SHOULD THE PUBLIC UTILITIES COMMISSION HAVE POWER TO CONTROL THE ISSUANCE OF SECURITIES?

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Inasmuch as this volume is devoted to a discussion of *State Regulation of Public Utilities*, and as I am not informed whether the issue to be discussed is the propriety of regulation of utilities at all, or, admitting the propriety of such regulation, whether to state or to municipal authorities should be accorded the right of regulation, I am somewhat at a loss how to attack the subject upon which I have been requested to contribute a paper. I shall assume, however, that it is desired that I discuss the issue whether the control of the issuance of securities should be assumed at all by whatever regulatory authority to which the work of regulation is entrusted.

The propriety of the regulation of securities of utilities, with particular reference to railroads, was the subject of a report to the National Association of Railway Commissioners at its annual session in Washington, October 28 to 31, 1913, by the committee on railway capitalization. The report of this committee advocating regulation of securities of railroads by the Interstate Commerce Commission was adopted, but not without considerable opposition. It was not there urged, however, by any one that there should not be some form of regulation, the principal question at issue being whether regulation should be by a method of control or a method of publicity. The report of the committee, which was adopted, recommended regulation by control as opposed to regulation by publicity. This report, with the discussion thereon, is found in the *Proceedings of the Twenty-ninth Annual Convention of the National Association of Railway Commissioners*, pages 114 to 223 and 238 to 257.

One of the first states which has attempted comprehensive regulation of the securities of utilities is Wisconsin. The fiscal affairs of utilities of that state, including railroads, have been under the jurisdiction of the Wisconsin Railroad Commission for several years. Regardless of that fact, the present chairman of the railroad commis-

sion of that state, a former chairman of that commission, now a member of the Interstate Commerce Commission, and the United States senator who has heretofore most strongly urged the necessity of the regulation of securities of utilities, are now apparently inclined to the belief that the regulation there prevailing is improper. Furthermore, the Railroad Securities Commission appointed by President Taft in 1910 and consisting of Arthur T. Hadley, President of Yale University, Chairman, Frederick N. Judson, Frederick Straus, Walter L. Fisher and B. H. Meyer, transmitted a report to the President, wherein, regardless of protestations on the part of members of this committee to the contrary, in my mind, is advocated a merely passive policy with reference to railroad securities and not at all a definite positive program looking to the correction of evils found by this commission to exist or the prevention of the recurrence of such evils in the future. This demands that cogent reasons be given by one who advocates active regulation of securities of utilities. In the face of these eminent authorities and with what I believe to be a careful consideration of every argument adduced by them, I state definitely my belief, first, that regulation of the securities of utilities is necessary, and, second, that such regulation must take the form of control by the public authority and is not satisfied by publicity alone. In the limit of this paper it will be impossible, however, for me to discuss in detail the merits of regulation by control as opposed to regulation by publicity. My views on that question are fully set forth in the report above referred to.

The opponents of regulation of the securities of utilities by control present two important objections to such regulation. First, they urge that the regulation of rates and service of utilities does not require the regulation of the securities of such utilities; and, second, the regulation of the securities of utilities brings about a guarantee by the government, if not in law at least in morals: (a) directly of the securities approved, and (b) indirectly of the securities already outstanding and issued prior to control by governmental authority.

Some of those presenting these objections urge that they are insurmountable and that no regulation whatsoever should be attempted. Others contend that they merely present difficulties inherent in the present scheme of regulation which is applied in Wisconsin, New York, California and other states. Those who urge that some method other than the method of control applying in

the states named should be applied, generally favor a system of publicity, and some there are who suggest that we should adopt a method similar to that imposed by the English companies act.

I join issue on each one of the objections raised. I am of the opinion that not one of them is valid against the system of regulation which is growing up in the various states following the lead of Wisconsin, wherein the affirmative approval of the governmental authority is required before stocks and bonds may be issued, and I shall discuss these objections in the order named to the extent that is possible in a paper such as this.

First, Can Adequate Regulation of Rates and Service of Utilities be brought about without Regulation of Stocks and Bonds?

On this question, Chairman Roemer of the Wisconsin commission, in a letter to the National Civic Federation, says:

"As I view the matter, the regulation of the issues of corporate securities is and must be for the benefit of the investors. It has no bearing independent of statutory provision upon the question of rates."

Mr. B. H. Meyer, formerly of the Wisconsin commission, now of the Interstate Commerce Commission, in discussing this matter before the National Association of Railway Commissioners in October last, said:

"With power to establish the value of the public utilities on the one hand, and adequate power to regulate rates and service on the other, I take it that the question of stocks and bonds is largely a question of public morals."

The Railroad Securities Commission has this to say on this point in its fifth recommendation:

> If we were compelled to assume that rates are to be materially influenced either in their making by the railroads or in their regulation by the government by the amount and face value of the stocks and bonds outstanding, it seems to your commission impossible to escape the conclusion that these securities should be issued only under governmental regulation. Your commission, however, believes that the amount and face value of outstanding securities have only an indirect effect upon the actual making of rates and that they should have little if any weight in their regulation.

Senator La Follette of Wisconsin, in the issue of *La Follette's Weekly* of January 31, 1914, editorially urges that regulation of the

securities of railroads is not necessary to the regulation of rates. In this connection he says:

"The fair value of the property is the true basis. The public need not concern itself with all the villainies of over-capitalization which abound in the history of every railroad in the country."

It may be well at this point to state that it is generally conceded that there is no difference in principle between the regulation of securities of railroads and those of other utilities, and herein I shall make no distinction between the several classes of utilities in this regard.

Eliminating any consideration of the investor, who, according to some of these eminent gentlemen, deserves no protection, it appears that two fundamental fallacies exist in their reasoning: first, that they have forgotten apparently that the amount of the rate is not all that must be considered, but the character of the service as well. While the rate may remain the same, if the service deteriorates or the character of the commodity furnished by the utility is impaired, plainly the patron of such utility is paying a higher rate, when we have regard to what he is getting for his outlay. Second, they have neglected to inform themselves that, although legally they are correct and legally the financial condition of a utility need not be taken into consideration in fixing rates and requiring service, yet actually such financial condition cannot be overlooked because it has always had and does now have a material effect on the rates and service of utilities.

That this is true in concrete cases is easily demonstrated. That it always will and must be the rule I believe is equally clear. Utilities, as other enterprises, are initiated, managed and owned by men. Men, in the main at least, prefer their own advantage. Thus the natural inclination of those controlling the destiny of any public utility leads them, when a choice must be made between public service and private advantage, to choose private advantage. Gain has been, is now, and always will be the prime motive of those engaged in public utility as well as any other business; and the service of the public is only secondary thereto. Therefore, we may naturally expect to find that procedure followed, in the absence of restraint, which is most likely to result in profits to those in control. In practice, those who initiate a public utility enterprise attempt to get as much out of it as is possible and put as little as possible in, with the

result that the enterprise starts with the maximum burden that can be imposed and not kill it in the beginning. Every dollar that is taken out, or rather withheld, by construction contracts, watered stock or discount on bonds, represents what is in effect a liability and a liability which, if it take the form of a debt as a bond or a note, *must* be paid and a liability which, if it represent water in stock, *will* be paid if those in charge of the property can possibly bring about such result. The design of every public utility manager is of course to pay his bond interest and then to bring his stock to par or better. These results are sought regardless of the amounts which have been received by the utility for such bonds and stock. If obligations which netted the utility less than par are carried and paid off in the end and if stock which has been sold for less than par ever goes to par, the extra funds to bring this about must come from the rates. When we view the history of utilities and see that in numerous cases the results here referred to have come about, we must conclude that in such cases at least capitalization *has* affected the rates; for such rates have been unquestionably higher by that amount than is necessary to pay the expense of doing the business and a reasonable return on the value of the property devoted to the public use. These men who have long studied this question, however, say that capitalization need not affect rates. We answer that historically it has done so, and we have no reason to believe that in the future it will not have a like effect. If we should put a certain amount of meal into a bag and go away and subsequently, on inspecting the bag, find more meal in it, we would probably be pardoned if we should conclude that the additional meal came from somewhere; and if only one person had had an opportunity to make the addition we probably would not be far wrong in concluding that this individual was responsible. And when in the case of a utility certain funds, ascertainable in amount, go in from proceeds of stocks and bonds, and thereafter we find there are funds much in excess of these amounts in the utility and the only source from which money has been acquired in the interim has been the rates, we must here again be pardoned for believing the extra funds came from these rates. Of course, this reasoning overlooks appreciation in lands and kindred property, but the valuation theory, urged as a solution of our rate troubles by the very men who say capitalization does not affect rates, presents this same complication. As a matter

of fact, however, practically the only public utility presenting the unearned increment problem as a substantial factor is the railroad. And can any one urge that the tremendous fortunes made from railroads by the Harrimans, the Goulds, the Hills, and others, not one of which resulted from dividends but from sale or retention of securities with small if any return to the railroad corporation itself, can be accounted for on the theory that the lands owned by these railroads increased in value to such an extent? It is well known that much of the property now in use by public utilities has been purchased and is being purchased from funds realized from rates. Consequently, such rates have been higher than necessary, and however able public authority is to make rates independent of and unaffected by capitalization it has not yet done so.

Because, then, of a perfectly natural inclination of mankind, the tendency is to put the minimum into the utility at the beginning and take the maximum out in the form of stocks and bonds. The same natural inclination leads men in control to take the maximum out thereafter in rates in order to restore the margin between the minimum contributed in funds and the maximum retained in securities. It is idle to say that these inclinations working on the one hand to get the maximum out of the utility and on the other to get the maximum out of the public, have no effect. Every one knows they have had an effect in the past and that, in the absence of restraint, they will have a like effect in the future.

It is very evident that corporations have but three sources from which to secure funds: stock, borrowed money, and earnings. With stock all, or mostly all, out at the beginning, with bonds issued to an approximation of the value of the property and with consequent inability to sell more, there is left but the rates from which to secure funds. When we meet a situation such as this it always is necessary to secure more from the rates in order to get extensions or betterments or else not have such extensions and betterments. We have today an exhibition of the result of impaired credit consequent upon the inability of the roads to sell more bonds under their present earning capacity, when we see the eastern roads applying to increase all of their rates in order that, with the higher earning power, additional money may be secured. When, as I have said, there is no possibility of getting money from the sale of stocks or bonds—the two main sources of revenue for the utility corporation—such corporation can-

not go forward unless it is enabled to do so from funds realized from its only remaining source of revenue, its rates. Thus by permitting those controlling the corporation without restraint to indulge their natural inclination and exhaust the two main sources from which revenue may be secured, as is always their tendency, we inevitably bring about a condition wherein through financial inability the utility cannot accord to its patrons those rates and that service to which they are entitled.

Thus, if no regulation is afforded, we will inevitably have utilities tending toward over-capitalization. This tendency will result either in higher rates, as it has in the past, or in poorer service, for you will have utility managers by natural inclination and often of necessity, when proper rates are imposed, curtailing expenses, restricting service and in every way possible tending toward the minimum service that can be rendered. Free to work their own will in their financial affairs and always tending, if not prevented, to over-capitalize and then held down to the minimum basis for earning through regulation of rates, utilities inevitably get into bad financial condition. This condition could be at least measurably prevented by putting restraint upon these natural inclinations by proper regulation of securities. I am prepared to cite examples from my own experience in regulation where needed extensions have not been made, added service denied and exorbitant rates maintained, because of the necessity of the managers of such utilities to pay interest upon debts which too nearly approximated or were in excess of the value of the property devoted to the public use. It would seem to be clear that it is better, both in the interest of efficiency of utility operation and of economy in governmental machinery, to prevent such a condition being brought about, rather than wait until it is produced and then seek to force a utility to give the service at the rates that are justified but beyond its financial ability to give, with the result that a long contest ensues during which service is impaired, investors defrauded and confidence shaken with no better condition after such contest than could have been brought about initially by proper regulation by the commission.

It appears, then, that failure to regulate securities permits bad financial conditions to grow up which impair the financial ability of the utility, and hence its service, until such bad financial conditions are remedied; and the remedy then unsettles conditions and

defrauds investors, while less effort by way of prevention would maintain the financial ability and bring about conditions naturally that now must be forced through receivers, courts and reorganization. In short, those who urge that the financial affairs of utilities should be let alone and that only rates should be regulated fail to see that they merely attempt to cure a condition which they admit is bad rather than try to prevent it. They further overlook the fact, that, if it is right to cure it, prevention is certainly justified. If, as we contend, over-capitalization naturally occurs in the absence of restraint and that over-capitalization is the usual condition which we meet, it readily appears that its cure must always be made at the expense of some one, as the money diverted through over-capitalization must be supplied from some source. Rarely will it be possible by human ingenuity to prevent its being supplied, partly, at least, from the rates; and what does not come from that source comes from the purchaser of securities. Prevention, on the contrary, through regulation, if effectively applied before it is too late, brings about readily the desired result and the imposition of reasonable rates and the requirement for efficient service are secured without injustice to any innocent party and without the long period of bad service always occurring when a utility loses its financial ability to do that which it is legally obligated to do.

Therefore, we conclude that the first objection that regulation of rates and service does not require regulation of securities is not well founded. It remains to consider the second objection which is that

Governmental Control of Stocks and Bonds Morally, at least, Commits Governmental Authority to Recognize Stocks and Bonds when finding Value for Rate-Fixing Purposes

Every argument I have yet met in support of this contention indulges, indirectly at least, the presumption that the governmental authority acting is not equal to the job. Now I quite readily admit, in the language of Dr. Milo R. Maltbie of New York, that "I would prefer to have no regulation to that which is not effective, for a form of regulation without substance is worse than no regulation." What I have to say has reference solely to competent and effective regulation.

Those empowered to regulate should, of course, be advised as to the legal effect of their acts. They should know, as Mr. Roemer of Wisconsin points out, that the contract between stockholders is protected against impairment by the federal Constitution and that "each share of any class is entitled to all the privileges of every other share of the same class." Likewise bonds issued under the same trust deed stand on the same footing regardless of when issued. And knowing these legal principles they should avoid taking any step with reference to present issues of either stocks or bonds out of issues authorized and partly out, without knowing the value behind those already issued. If, in the case of a corporation a part of whose securities have been issued before regulation was applied, it is found that over-capitalization exists, no new issue should be permitted which will be on a parity with what is already out, thereby becoming diluted by the water already in the enterprise. Under a proper stock and bond law the burden is upon the utility to satisfy the commission that the application is justified and unless those in control of the corporation will take such corporate steps as are necessary to overcome the difficulty presented by equal participation, then no securities should be permitted. The financing by preferred stock, which is now being done in various states, is an answer made by utility corporations themselves to the argument here considered, and an answer that will always be made if utilities commissions are firm and have an understanding of their work. The California commission, for example, has laid down the rule, and adheres to it strictly, that any utility in a financial condition which the commission would not approve if presented originally to it, but nevertheless not actually insolvent or in such a bad way that its condition is doubtful, may take any financial step which leaves it in a better financial state. It is allowed to progress toward a satisfactory financial condition but it must not go backward. Its option is to advance or issue no new securities of any sort. If an agency is actually, although not legally, insolvent by having debts in excess of its assets, it must reorganize before it can issue more securities. By this rule the burden is placed, as it should be, upon the utility to present a satisfactory plan of finance; and if any of the *legal* difficulties suggested by Mr. Roemer are still present the application is not approved. No utilities commission need, nor ever should, permit the issuance of stocks or bonds in any case where such permission will serve, by reason of partici-

pation, to imply a legal sanction of outstanding issues where such outstanding issues have not the proper property values behind them. In the case of doubt as to the property values behind the securities the commission can quite properly withhold its approval until the applicant utility shall have presented satisfactory evidence upon which the commission can act. With all due respect to the opinion of the eminent senator from Wisconsin, as voiced in his present opposition to the railroad securities bill pending before Congress, I am plainly of the opinion that he has overlooked the distinction between a rate case, where the burden is upon the public, and a securities case, where the burden is upon the utility. In the former some one wants something against the utility. In the latter, the utility wants something, and to get it, it must disclose and not suppress evidence. Overlooking this distinction the senator advises us, as regards railroads, to wait until the Interstate Commerce Commission shall have finished its labors in valuing railroad properties, and then by rates having proper relation to such value to get rid of the water then found to exist in the railroads by rendering them unable to pay their obligations which shall have been incurred in the meantime in excess of what should have been incurred. And it is also evident that it is thought that water now exists and that more water will go in in the future while the valuation is being made, for plainly if it were expected that nothing but the proper financing would take place there could be no objection to, although of course no need for, governmental action on the ground that such action would serve to recognize improper financing. In short, the very argument that no governmental restraint should be imposed, on the ground that improper securities might thereby be validated, presupposes, of course, the fact of the issuance of such improper securities in the case. We are justified in assuming that the lack of restraint hereafter pending the final completion of the stupendous work of valuation of railroads, as required by Congress, will leave the roads open to do more of this very thing and further to impair the financial standing of these properties.

And this is the advice of those who urge that we must not regulate securities because by so doing we incur a moral obligation with reference to such securities! Too many securities have been issued in the past under no regulation. Too many will be issued in the future we know. Yet in the face of this condition we should do

nothing because our hands may be soiled also with guilt! Having the power to prevent and not preventing a crime, it occurs to me, imposes some kind of moral obligation which possibly may be greater than that which attaches after an unsuccessful attempt to prevent such crime. Knowing that securities are being, and have been, issued and sold that should not be issued and sold, nevertheless let us permit it until in our good time we get ready to contract the earning power of the utilities through rates so they may no longer pay their obligations with consequent loss to investors and impairment of financial ability of the corporations properly to serve the public, all because of our fear of incurring a moral obligation by attempting to do something. Admitting we incur no legal obligation by regulation, as I think I have shown is the case when we ought to escape such legal obligation, there is not one cogent reason advanced which leads me to believe that we are not morally more bound by failure to regulate than by regulation. The corporation is the creature of the state. Every step which may be taken in issuing stock or authorizing bonded indebtedness must be taken in compliance with some statute. The state now regulates utility corporations, in this regard, as it does all corporations and by so doing empowers such corporations to take advantage of the public and empowers the officers of such corporations to take advantage of the corporations themselves to the hurt of such corporations and the public. Add to this the fact that government knows not only that these things may be done, but also that they have been and are being and will be done, and, to my mind, we have a pretty large moral obligation in itself and one that is minimized rather than accentuated by taking additional steps to prevent abuses possible under the authority already conferred. To relieve ourselves of any moral obligation at all we must dispense with the corporation itself. But having created the corporation with power of oppression under present economic conditions, can we excuse ourselves, if it oppresses, by the plea that, by an attempt to prevent such oppression, we become *particeps criminis?* Being entirely responsible for every power of this fictitious person wherein it issues securities, we cannot avoid responsibility for what it accomplishes by means of such powers.

As palpably erroneous is the contention that, by approving securities, we will mislead investors. The very able chairman of the Wisconsin commission in a letter to the National Civic Federation

states that, by authorizing the issuance of securities and directing their investment, the governmental authority involved

> is likely to cause certain investors who purchase such securities as an investment without knowing anything of the management of the corporation or the possibilities of the enterprise to rely upon the state's sanction of the issues. These are the investors who need protection and who, I am apprehensive, will often be the victims of investments in ill-advised and mismanaged public service corporations whose securities have been authorized by state commissions. The business man who deals in such securities needs no protection.

These views of Mr. Roemer deserve respect because of his great ability and long experience, but at the risk of appearing presumptuous, I respectfully suggest that a little analysis will show them to be fallacious. Who buys the bad securities today? Not the business man who deals in securities, for he, with or without regulation, makes his own independent investigation. So as to him regulation effects no change. Who then buys securities today under no regulation without making an investigation for himself? The unwary, of course. Who will buy them under regulation, according to this argument, without independent investigation? Here again the unwary. The whole argument then is "unwary investors are now misled into buying bad securities. Make your securities better by effective regulation and issue fewer of them for the same amount of property and thereby victimize the man by protecting him and giving him more for his money."

I have attempted to deal with the more important controverted questions involved in regulation of securities. I am strongly of the opinion that not one of the arguments advanced against regulation will bear analysis. I am convinced that these arguments are adduced in contemplation of ineffective regulation and are directed more against what has been and is being done in some quarters by way of regulation than against what the state can do under proper statute carefully and intelligently administered.

In summarizing the argument on the first objection it is well to have in mind what the Railroad Securities Commission had to say with reference thereto. In this connection I call attention to the following comment:

> They (the railroads) have therefore been less able to give the shippers or the travelers the facilities that are requisite no less for the convenience and safety of the public than for the profitable utilization of the railroad itself

To the extent that we lessen the debt we shall increase the power of the railroads to raise money when the public needs added facilities and shall at the same time reduce the chance of default and lessen the severity of commercial crises.

And to what Dr. Maltbie of the New York Public Service Commission, first district, one of the clearest thinking men engaged in regulation work in the country, also says:

The state owes a duty towards investors as well as it does towards shippers and passengers. Further, proper regulation of securities will ultimately affect rates and service. It may not immediately but in the long run better service and lower rates will be given by corporations that are upon a sound financial basis than by those having a great over-capitalization and unsound finances.

In short, as pointed out at length herein, whatever *ought* to be the result of over-capitalization and however much men may theorize, the fact remains that it *has* and *does now* affect rates and service and a proper regulation of rates and service cannot be had without regulation of securities.

In answer to the second objection, it appears that the state, by methods easily available, can regulate and is regulating securities without directly or indirectly validating or approving existing outstanding securities that should not be approved. Besides, the state incurs an obligation from an ethical standpoint in putting a corporation, by permission, in the way of doing a thing which results in a fraud and particularly is the state morally derelict if after having conferred power on a corporation and having seen such power used in a way to work injustice, at having the power to step in and prevent such injustice, fails to do so. And any restraint applied which tends to prevent such improper procedure on the part of corporations instead of morally involving the state to an extent beyond which it is now obligated, tends on the contrary, to lessen the moral responsibility.

As regards securities that are approved by the state, under the proper precautions pointed out herein, I can give myself no great concern as to the effect of such approval. If the public utility commission does its duty, the approved securities should be good and if it sees to it that the proceeds are honestly invested in the property and takes care that securities approved are not diluted through participation with other securities not approved, then why should not these securities be recognized in the rates? But regardless of

any difficulties that confront those empowered to regulate securities, the condition under regulation is so immeasurably better for utility, patron and investor, as far as can now be determined, that I am at a loss to understand the Jeremiah-like attitude of those who some years ago indulged the same childlike faith in the efficacy of regulation that some of the rest of us now display. But I could the better understand and perhaps agree with those formerly urging regulation and now so fearful of its results, if they would point out wherein it has failed where effectively applied, instead of contending that it may produce results that have not yet come upon us. The evils of over-capitalization are familiar to us all. The logic of regulation seems to me to be irrefutable. Where properly carried on it is certainly preferable to the former condition, and until something more substantial than mere fears of results that cannot be shown as yet to have materialized is urged against the propriety of regulating securities, such regulation certainly should not be rejected and a reversion to former admittedly bad conditions invited.